7:00's Report

"Everything you need to know about the markets by 7a.m. each morning, in 7 minutes or less."™

October 29th, 2014

Pre 7:00 Look

- Futures are basically unchanged after a quiet night of macro news as everyone looks ahead to the Fed later today.
- Europe is leading markets higher, rising in sympathy with US markets after another decent night of earnings.
- Economically Japanese IP beat expectations (up 2.7% vs. (E) 2.2%) and an ECB Lending Survey showed an easing of credit standards, but the reports aren't moving markets.
- Econ Today: FOMC Announcement (2:00 PM).
- Earnings Today: GRMN (E: 0.72), HSY(E: 1.08), WLP (E: 2.28), MET (E: 1.38).

Market	Level	Change	% Change
S&P 500 Futures	1977.50	-2.50	-0.13%
U.S. Dollar (DXY)	85.47	-.003	-0.10%
Gold	1227.10	-1.70	-0.14%
WTI	82.23	.80	0.92%
10 Year	2.284	.027	1.20%

Equities

Market Recap

The "V"-shaped rebound continued yesterday as stocks rallied hard despite lackluster economic data and mixed earnings ahead of the FOMC. The S&P 500 rose +1.19%.

Stocks were higher from the outset Tuesday as strength in China led to gains in Europe, which sent futures higher pre-open. The main positive impetus was talk of more free market reforms in China (although nothing concrete was declared and it was mostly sentiment driving markets higher).

Russell 2000: Small caps continue to bounce back and for the first time in over a month the Russell 2000 is back above its 200 day moving average.

Good European earnings also helped and markets ignored the TWTR miss. The major news items of the day were out before the bell, and despite a drop in the Case-Shiller Home Price Index and an ugly durable goods report (more on that later), markets opened strong.

From there it was basically a "melt up" day as the S&P 500 decisively broke through the 100-day moving average and then also through the 50-day. This caused more short-selling and "chasing" on the long side as portfolio managers rushed to add long exposure.

The remainder of the day was very quiet but the "painful" rally continued throughout the afternoon. We saw an acceleration (and intensifying) of that "pain" during the last two hours of trading, despite the lack of any material positive catalysts. Stocks went out at the highs of the day.

Trading Color

It was a cyclical-led rally yesterday, as the Russell 2000 surged higher (up +2.9%) on simply massive short-covering. The index traded above the 200-day moving average for the first time since September 19th.

Market	Level	Change	% Change
Dow	17,005.75	187.81	1.12%
TSX	14,624.25	155.25	1.07%
Brazil	52,330.03	1826.37	3.62%
FTSE	6,443.96	41.79	0.65%
Nikkei	15,553.91	224.00	1.46%
Hang Seng	23,819.87	299.51	1.27%
ASX	5,447.68	-4.92	-0.09%

Prices taken at previous day market close.

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Sector-wise the rally was broad as all 10 sub-sectors finished higher, although defensives lagged (utilities, consumer staples and healthcare all rose less than +1%).

Market	Level	Change	% Change
DBC	22.28	.18	0.82%
Gold	1228.20	-1.10	-0.09%
Silver	17.21	.049	0.29%
Copper	3.0925	.0285	0.93%
WTI	81.30	.30	0.37%
Brent	85.92	.09	0.10%
Nat Gas	3.665	.104	2.92%
RBOB	2.1850	.0148	0.68%
DBA (Grains)	25.77	.05	0.22%
Prices taken at previous day market close.			

Despite multiple sell-side firms following Goldman's lead in downgrading the energy sector, XLE bounced back from Monday's beating, rallying +2.28%. Meanwhile tech, industrials and consumer discretionary all rallied more than +1%.

So, the internals of the rally, volume aside, were healthy. Cyclicals handily outperformed defensives on short-covering and a "beta chase" as markets moved closer to new highs.

On the charts the S&P 500, in 2 weeks, has basically repaired all technical damage done during the latest sell-off, as the SPX is now above all major moving averages.

Bottom Line

Searching for a reason for yesterday's melt-up is fruitless—no news item or earnings report was responsible for the surge higher in stocks. As stated, the real reason for the rally was short-covering/chasing. So, nothing fundamentally got any better yesterday (and depending on your opinion of durables, things may have gotten slightly worse).

But, with the FOMC expected to be dovish and many people (me included) still wary of this market, the "pain trade" remains higher still (although again I don't see a major catalyst pushing stocks materially above 2,000).

With regard to putting new money to work, I still favor Europe (EUFN, HEDJ) over the S&P 500 for anything other than the very short term. If markets do continue to grind higher, Europe will have to play catch-up in a meaningful way. From a risk/reward standpoint, it continues to look more attractive than the SPX over the coming months, given the S&P 500 is now 25 points from the highs (just over 1%) and 175 points from the recent lows.

Other than incrementally adding to "Europe," I'm holding domestic allocations. I'd prefer to buy strength and a breakout rather than to jump back in the pool at these levels.

FOMC Preview

Despite the official end of QE, this meeting should go generally according to plan, although there are 4 key areas where potential surprises are lurking. From a market standpoint, the FOMC is expected to be "dovish," so most of the surprise risk is on the "hawkish" side (although it's admittedly remote).

There are four keys to watch for in today's FOMC announcement:

1. *End of QE:* Despite Fed President Bullard's comments last week about potentially halting the tapering of QE due to global economic weakness, it is universally expected (and priced in) that the FOMC will end QE at this meeting. To say it would be a dovish shock if they did halt the taper would be an understatement.

2. *Potential Removal of "Considerable Time":* This phrase and its potential removal was in focus at the September meeting. Basically, "considerable time" is thought to mean 6 months. So, if/when this phrase is removed from the statement, it's anticipated that rate hikes will begin 6 months later. Given that it's October, 6 months from now is March, which is earlier than current market expectations for rate "lift-off." **Expectation: "Considerable Time" will remain in the statement. Surprise Potential: Hawkish.** If the phrase were removed, it would be a "hawkish" surprise with stocks, bonds and gold falling while the dollar rises.

3. *Potential Removal of "Significant Underutilization of Labor Resources":* This is the other key phrase to watch. This refers to the slack in the labor market, and a removal of this phrase would imply a material upgrade to the jobs market. This would be "hawkish." **Expectation: The phrase stays or may be slightly modified—but not removed totally. Sur-**

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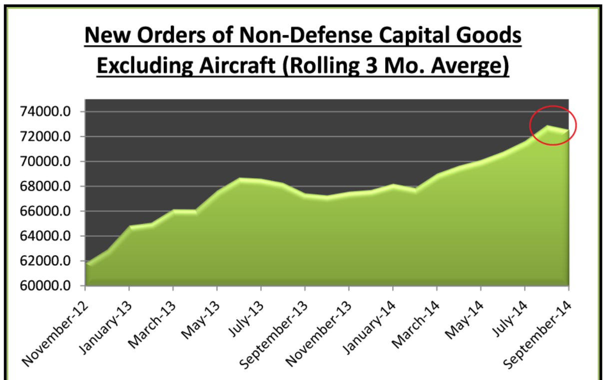
prise Potential: Hawkish. If "significant underutilization of labor resources" is removed entirely, it'll be a hawkish surprise with stocks, bonds and gold falling while the dollar rises.

4. *Downgrade of Inflation:* Starting in July, the FOMC basically upgraded its outlook on inflation, saying that it was moving toward its 2% goal and that downside risks to inflation had been diminished. But, given the recent drop in CPI, it's possible the FOMC may re-insert some cautious language on inflation. It could say something like "inflation consistently below 2% poses a risk to economic performance, and the Committee will carefully monitor inflation going forward." **Expectation: It seems like the FOMC could re-insert cautious language about inflation. Surprise Potential: Dovish.** This shouldn't elicit too much of a market response, as we've already largely priced in a dovish meeting, but expect the dollar to sell off and bonds to rally (and stocks to rally modestly also) if the Fed again sounds cautious on the inflation front).



Durable Goods: For only the second time this year the 3 month moving average of durable goods orders turned negative.

Economics

Durable Goods

- September Durable Goods were –1.3% vs. (E) 0.9%, badly missing expectations.

Takeaway

This was a bad number and frankly it was worse than the market reaction would imply. Not only was the headline weak, but the more important sub-indicator of "Non-Defense Capital Goods Excluding Aircraft" (NDCGXA)—which gives a much better gauge of the level of business spending/ investment—plunged -1.7% *and* the previous month was revised lower. More disconcertingly, the three-month moving average of NDCGXA turned negative for the first time since February.

Part of the reason this weak number was shrugged off by stocks was because it's not known how much a drop in foreign demand (courtesy of the stronger dollar) caused the decline. Also, while Durable Goods is a loose proxy for the Non-Residential Fixed Investment in GDP, the soft report yesterday didn't materially reduce expectations ahead of this morning's Q3 GDP report. The decline in orders looks to be offset by a build in inventories (making the effect on GDP minimal).

But, both seem a bit short-sighted. First, we won't know that until the September Foreign Trade numbers are out next week. Regardless, whether the fall-off in demand is foreign-based or domestic, it's still not a positive. Second, although inventories may save Q3 GDP, it's not like that's a positive for the economy. All it does is pull forward that economic activity from Q4.

Bottom line, this is one of the weaker numbers we've seen in a while. And, while it alone won't change anyone's economic outlook or FOMC policy, it's not exactly the best sign from an economic standpoint.

Commodities

Commodities were mostly higher yesterday, with the only notable outlier being gold, which closed just slightly in the red, down -0.06%. The dollar traded lower for the third session in a row, helping commodities rally. However, a lot of the moves were a result of positioning ahead of the FOMC announcement today. The benchmark commodity index, DBC, gained +0.82%.

Market	Level	Change	% Change
Dollar Index	85.475	-.086	-0.10%
EUR/USD	1.2737	.004	0.31%
GBP/USD	1.6131	.0011	0.07%
USD/JPY	108.10	0.29	0.27%
USD/CAD	1.1182	-.0062	-0.55%
AUD/USD	.8851	.005	0.57%
USD/BRL	2.47	-.0518	-2.05%
10 Year Yield	2.284	.027	1.20%
30 Year Yield	3.057	.023	0.76%
Prices taken at previous day market close.			

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Natural gas was the best performer yesterday with futures rallying +2.81% to print an outside (or, one-day) reversal on the daily chart. This is a sign of near-term seller exhaustion, and obviously bullish for natural gas. But, futures failed right at the 1 month old downtrend line that was largely responsible (in a technical sense) for pushing futures down through multiple support levels in the $3.70s and $3.80s.

Bottom line, yesterday's session was a near-term step toward the technical situation of the natural gas market turning much more bullish. But, until futures close above the longer-term downtrend line that stands near yesterday's highs, the situation is neutral at best.

Elsewhere in energy, WTI crude oil finished slightly higher, up +0.48% yesterday ahead of weekly inventory data and the FOMC announcement today at 2 p.m. (Just to clarify, crude oil generally does not trade off of central bank announcements. However, given the current concerns over global growth, the market will be more sensitive to any unexpected dovish or hawkish verbiage.)

On the charts, WTI rallied to the first incremental high in a week yesterday as futures continued to hold support at $80/barrel. Today will be important for the energy market as the EIA report and FOMC will both have the ability to move the market (either spur a short-covering rally or push futures down through all-important support at $80)

In the metals, copper extended weekly gains, adding +0.90% yesterday as traders remained focused on the news that the 3rd largest copper mine in the world, Freeport-McMoRan's (FCX) Grasberg mine in Indonesia, is only operating at 60% to 70% of capacity as employees are beginning to strike because of unsafe working conditions.

But, apparently the union's agreement with FCX prohibits labor strikes, so union leadership and FCX officials are working together to see normal operations resume as soon as possible. So, bottom line, the current strength in the copper market is likely going to be short term. Once the strike is resolved, market focus will return to demand speculation and global growth concerns—both bearish influences.

Currencies & Bonds

The U.S. Dollar Index fell for the third-straight day ahead of the FOMC meeting, but was also pushed lower by the weak Durable Goods number. We closed the day with the DX trading around 85.46 (-0.10%). Ahead of the post-FOMC meeting announcement, we should see this stay down in this area.

We did see the euro trade higher, catching wind with some short-covering behind it. The Fed meeting is going to dictate a lot of things, and the reaction to the U.S. dollar might be played out here.

The Japanese yen wasn't able to take advantage of the weaker U.S. dollar as much yesterday. The yen leaned on the 108.00 level for most of the day. Despite the lack of action here, the market is looking bullish based on events in Japan. A stronger than anticipated retail sales number (2.3% vs. (E) 0.6%) and the continuing Abe cabinet scandal (Trade Minister Yoichi Miyazawa let his political support group pay for an outing to an S&M bar in Hiroshima). It seems that Abe's support, which is still strong, is under a bit of an attack, which is a negative on Abenomics and should be yen-positive. It looks like short term "risk off" money continues to exit the trade. Despite the strength, though, I still remain cautious on how much more near-term upside there is in yen.

Bonds were down early Tuesday (30-year down -0.44%) but caught a bid on the soft Durable Goods report. Auction-wise, the 2-year was mixed. The bid to cover was 3.11, the lowest since last September, but what bidding there was looked be aggressive, as the actual yield was 0.5 basis points below the "When Issued"—which isn't bad considering the yield was the second lowest of the year. Despite Fed rumblings about rate hikes mid-next year, support for near-term bonds remains.

Have a good day,

Tom

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Position Sheet

Tactical Trading/Investment Account (Time frame of a few weeks to months).

Date	Position	Open Price	Stop	Strategy
9/11/14	EUM	24.05	None	*Short Emerging Markets. With the dollar surging higher and the global bond yields rising, this should put pressure on the emerging markets, as money rotates out of those economies back towards developed markets. Original Issue*
9/4/14	HEDJ EUFN EWI EWP	59.35 24.67 16.44 41.34	None	*"Long Europe" Portfolio. The move by the ECB to start a private market QE program, combined with the impending TLTROs, should give the European economy a significant boost over the coming months. HEDJ remains the best way to hedge out a falling euro, while higher beta sectors of the EU economy (financials, Italy, Spain) should rally the hardest. Finally, the moves should end the German bond mania, which should weigh on Treasuries. Original Issue*
7/21/14	UNG	20.98	None	*Natural gas is a supply/demand based trade. While injections over the summer have replenished supply, we are still 15% below historical levels, with the winter heating season drawing near, Natural gas in the highs $3.00's appears to be a value. Original Issue.*
12/13/13	FCG XOP	18.97 65.62	None	*Natural gas supplies low, increased demand, E&Ps at a value. Original Issue.*

Longer Term Macro-Trend Investment Account (Long term time frame of months/quarters).

Date Initiated	Strategy	Position (s)	Investment Thesis
November 2012	**Long Japan**	**DXJ/YCS**	*The election of Prime Minster Abe in late 2012 resulted in massive monetary and fiscal stimulus designed to break Japan out of decades long deflation and stagnation. The resulting efforts will be yen negative/Japanese stock positive for years to come.*
Strategy Update (10/13/14): The yen hit our target of 110 vs. the dollar and DXJ traded basically to its all time highs in early October, but now we are seeing a much needed correction. Longer term, I remain a bull on Japan/bear on the yen, but this trend will likely pause for some time, and I'd book any profits in those positions for accounts that don't have a very long time frame (and can stomach a correction).			
April 2013	**Short Bonds**	**TBT/TBF/ STPP/KBE**	*The 30 year bull market in bonds is over, as the Fed begins to gradually remove stimulus, the economy recovers, and inflation slowly begins to increase.*
Strategy Update (10/13/14): Treasuries are once again at new highs for the year, as a floundering European economy and worries about a stock market correction trump better economics here in the US. The fundamentals for this trade remain decidedly negative, but once again money flows have trumped fundamentals in the near term.			

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Asset Class Dashboard

(Updated 10.27.14)

This page is meant to provide a general outlook for the path of each major asset class and is updated at the start of each week.

Near Term Trends are provided primarily for tactical and trading accounts (Time Horizon of weeks and months).

Long Term Trend is provided for longer term asset allocation models/retirement accounts (Time Horizon of Months/Quarters).

The "Best Idea" represents our best idea at the moment. Not all best ideas are trades we make—they are provided for idea generation.

	Near Term Trend	Long Term Trend	Market Intelligence
Stocks	**Neutral**	**Bullish**	*The S&P 500 bounced back in a big way last week thanks to the ECB considering buying corporate bonds, good global economic data, and good earnings. Concerns about global growth and EU deflation remain, but data is helping calm those worries. Near term stocks could sprint higher into the FOMC but I still remain unconvinced on new all-time highs in the near future.*
Best Idea: Buy Regional Banks (KRE). **Best Contrarian Idea:** Buy Energy (XLE)			
Commodities	**Bearish**	**Bullish**	*Commodities were lower but bounced late in the week as the stronger dollar didn't weigh on the complex as much as usual. Gold underperformed on dollar strength and general "risk on" while WTI Crude consolidated in the low $80.00's.*
Best Idea: Buy Oil (USO) **Best Contrarian Idea:** Buy Grains (DBA)			
U.S. Dollar	**Bullish**	**Bullish**	*The Dollar bounced last week thanks mainly to weakness in the euro, which fell after the Reuters article regarding the ECB buying corporate bonds. The FOMC is obviously in focus this week, but unless they materially surprise markets by being hawkish I would expect a chop sideways in the dollar over the near term.*
Best Idea: Sell the Yen (YCS) **Best Contrarian Idea:** Long British Pound (FXB)			
Treasuries	**Neutral**	**Bearish**	*Treasuries declined last week but only marginally so, and definitely less than you would have expected given the huge rally in stocks. Economic fundamentals continue to be bond negative, but European money flows are still supporting Treasuries, and until the EU economy shows some life, Treasuries will be well bid.*
Best Idea: Short "long" bonds (TBT) **Best Contrarian Idea:** Short High Yield Bonds (SJB)			

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